STATE OF ARIZONA

Janet Napolitano, Governor

Budget Briefing Materials
Fiscal Year 2009

January 18, 2008

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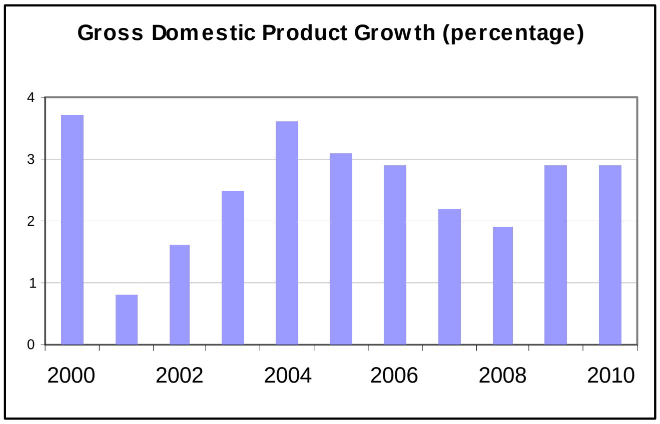
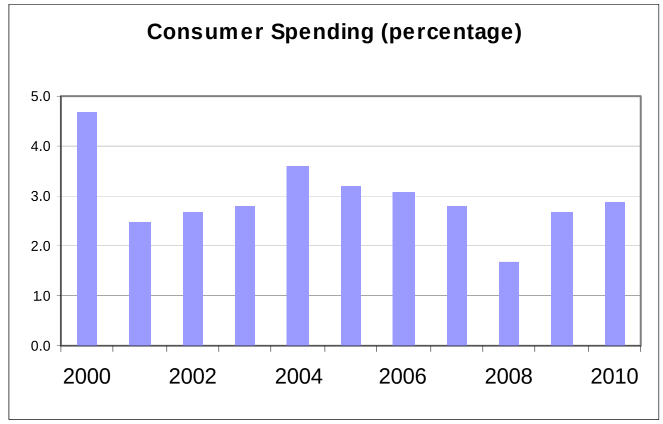
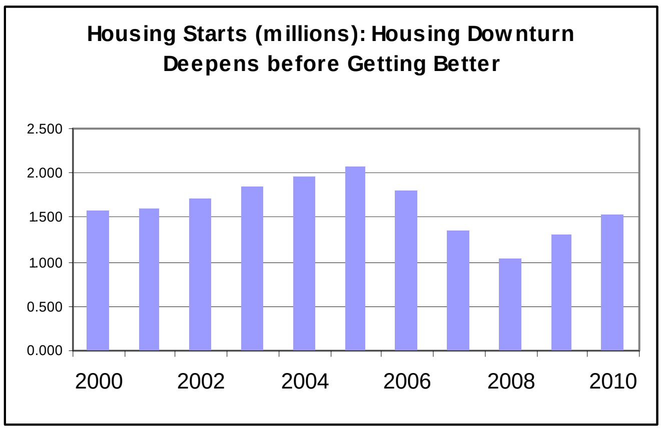
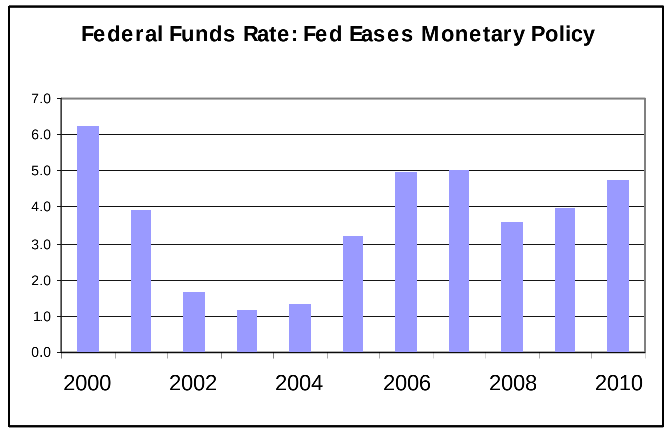
National Economic Indicators – Calendar Years 2006 Through 2010









Source: Global Insight

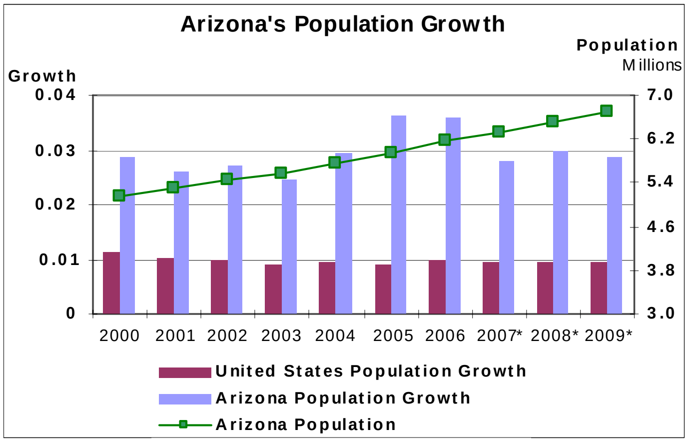
I. National Outlook

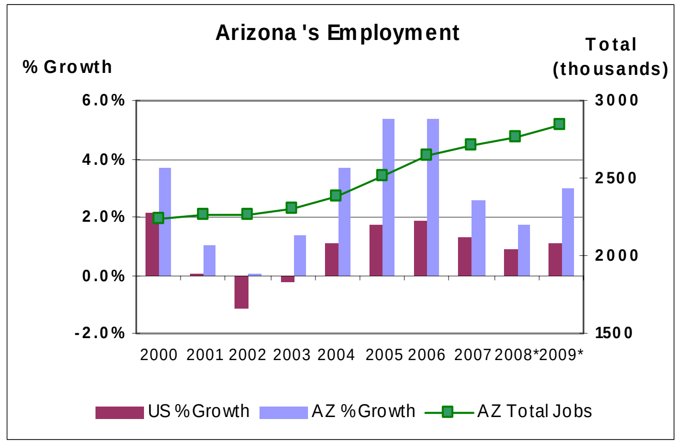
- Growth in real Gross Domestic Product (GDP) during 2006 was solid, at 2.9%; GDP growth is expected to slow and is projected at 2.2% in 2007 and 1.9% in 2008, before recovering to 2.9% in 2009.
- Employment growth in 2007 was moderate at 1.3%, and is slowing with estimated growth of 0.8% in 2008.
- Consumer spending is slowing as consumers face declining home prices, with an estimated 2.8% growth rate in 2007, slipping to 1.7% in 2008.
- The Fed fund rate is likely to ease to help boost economic growth.
- Business spending has been consistent and robust in the past five years, is likely to slow through the first three quarters of 2008.
- The dollar continued to fall in 2007, and further decline is anticipated in 2008 at a moderate level. The decline of the dollar makes US exports cheaper, therefore promoting greater US exports, helping to boost GDP growth.
- Trade deficit is likely to narrow the gap to $755 billion in 2007, and is expected to improve further in 2008.

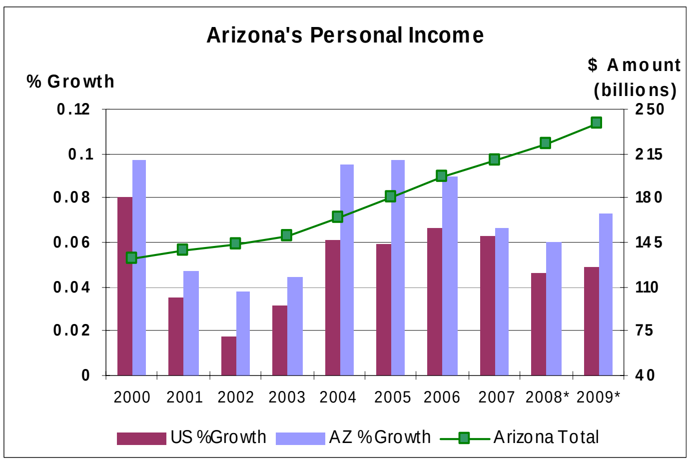
II. National Risks

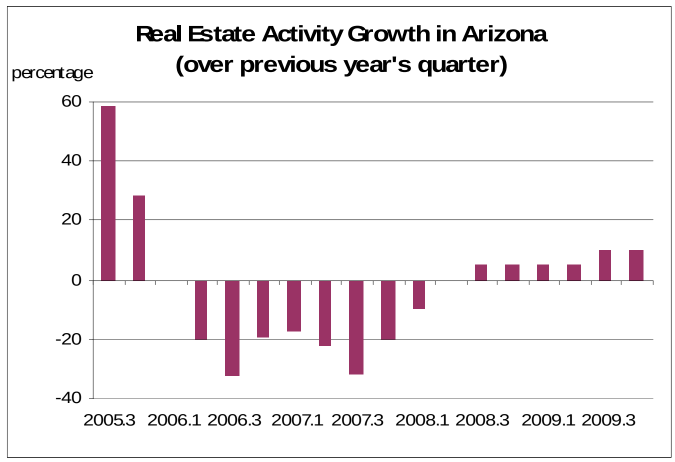
- Deeper declines in housing prices, tighter credit availability, plus high energy prices could lead to further contraction in consumer spending.
- Possible spillovers from the hardship of the Midwest's structural manufacturing slump could cause further erosion in the economy.
- Energy prices: If energy prices remain at high levels, inflation rate could rise, limiting the Fed's ability to provide credit relief for the economy.

Arizona Economic Indicators – Calendar Years 2006 Through 2009









Source: US Census Bureau, BEA, Arizona DES
*2008 and 2009 are projections from Census Bureau, Global Insight, Arizona DES, Arizona Blue Chip, and ASU

III. Arizona Outlook

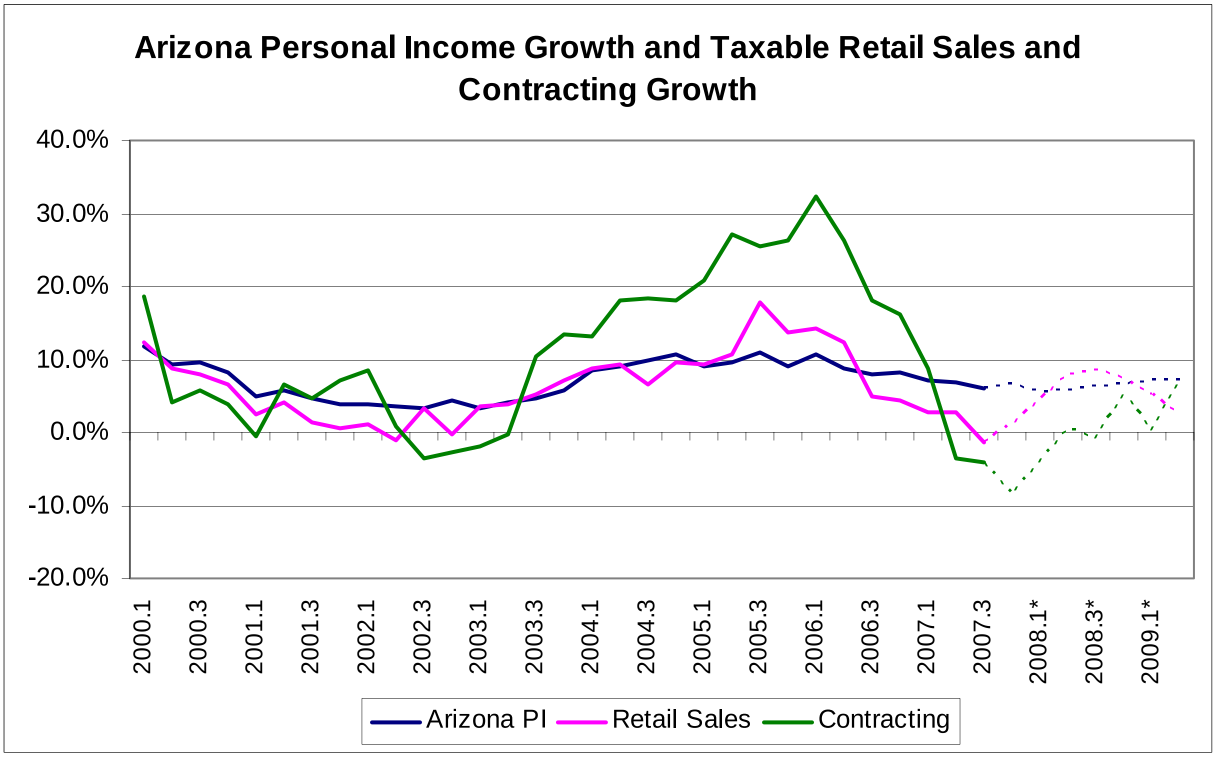
- Population growth in 2007 was 2.9% annually, ranked 2nd in the nation; in-migration/in-flows remain strong.
- Employment growth was strong in 2006 with 5.4% growth, but slowed sharply in the 2nd half of 2007. Arizona economy is expected to continue to grow at a lower estimated growth rate of 2.5% in 2007 and 1.7% in 2008, and is expected to maintain a position among the leaders in the nation.
  - From January 2003 to November 2007, Arizona added 500,500 jobs.
  - Arizona's unemployment rate, currently at 4.1% is lower than the national average of 4.7%
  - Big corporations, such as Intel, are expanding in Arizona, creating new high-wage jobs.
- Personal income (PI) growth for 2006 of 8.9% ranked 3rd in the nation (after Louisiana and Wyoming); PI growth has slowed to 6.7% in the first 3 quarters of 2007, and is expected to grow at 6.0% in 2008.
- Real estate activities decreased by 23% in 2007, and are expected to further decrease in quarter 1 of 2008 before slowly recovering to modest growth in the second half of 2008 and into 2009.
- Consumers continue to spend at a slower rate; retail sales are estimated to grow 4.4% in 2007, and 4.2% in 2008, according to Arizona Blue Chip's consensus forecast.

IV. Arizona Risks

- Any prolonged national downturn will adversely affect the state as it has in the past. Arizona's export, construction and hospitality industries would suffer.
- Arizona is more exposed than most states to the real estate cycle. The state enjoyed considerable growth and prosperity in the up trend of the cycle and in 2007 will experience a drag due to the slowing of real estate activity.

Impact of the Economy on Revenue Collections

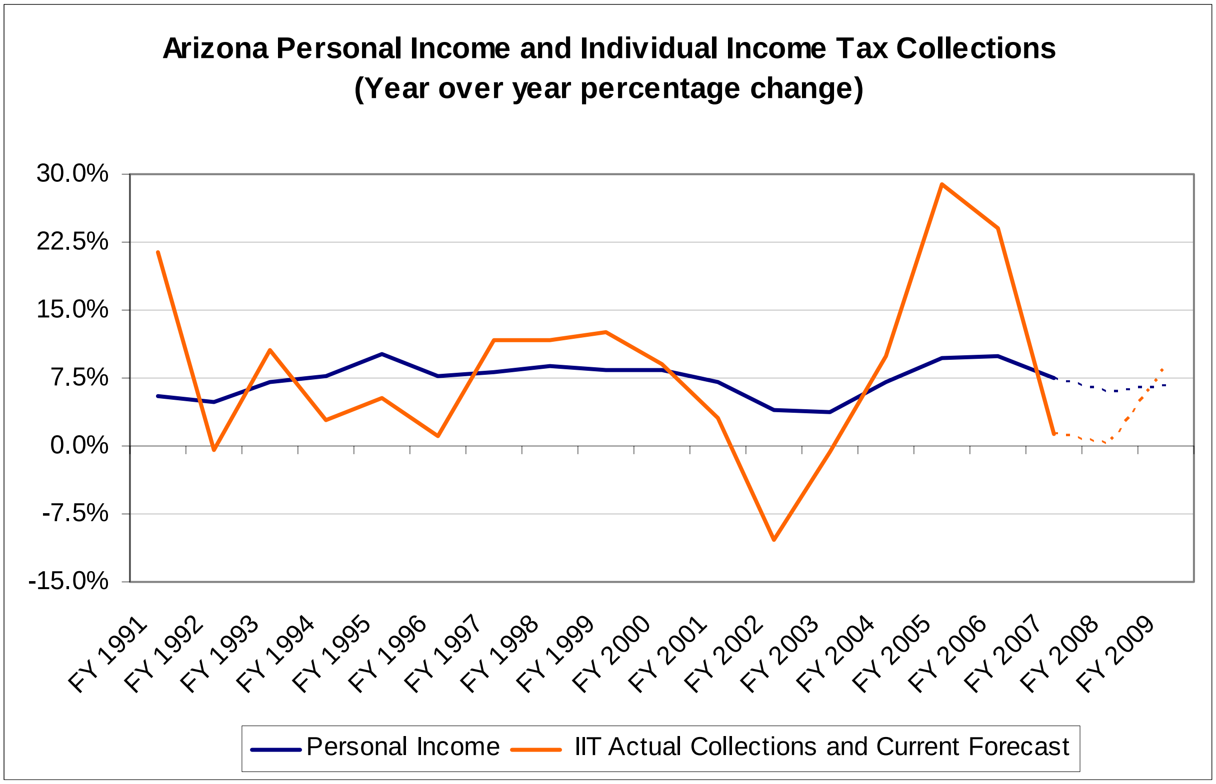
Economic Activity: Arizona will continue to enjoy rates of overall economic growth in aggregate wages and salaries that outstrip growth in the nation by several percentage points. Growth is fueled by a strong export sector in the States leading industries; hospitality, electronic manufacturing, aerospace and defense industries. Nevertheless, as the housing market experiences a slowdown, revenue collections are expected to grow at a slower rate before returning to a normal, healthy growth rate.



(*Note: dotted lines represent forecast)

Taxable Retail Sales Collections: The pace of retail sales activity has slowed considerably over the last six months in Arizona. Tax collections in Arizona are growing at a rate far slower than the overall Arizona economy. The reasons for the slower growth are primarily related to the high consumer spending due to easy credit availability and from car manufacturer rebates during the strong economic period of 2005 and 2006. Consumers have ratcheted back expenditures on automobiles and housing related consumer durables. The expectation is that retail sales collections will display more normal growth patterns, albeit from a lower base, as we move into the second half of FY 2008 and continue to improve into FY 2009, reaching a pace that matches growth in the overall economy 12-18 months from now.

Other taxable TPT categories: Overall TPT collections in the State are also strongly influenced by “use” tax collections, contracting collections, and utilities collections. The use category is in turn buffeted by decisions of businesses to expand plants or stores, purchase new equipment, and by assessments on fuel acquired by utility companies. Contracting collections will be very slow for the foreseeable future with strong commercial sector collections limiting the downside from declining residential collections.



(*Note: dotted lines represent forecast)

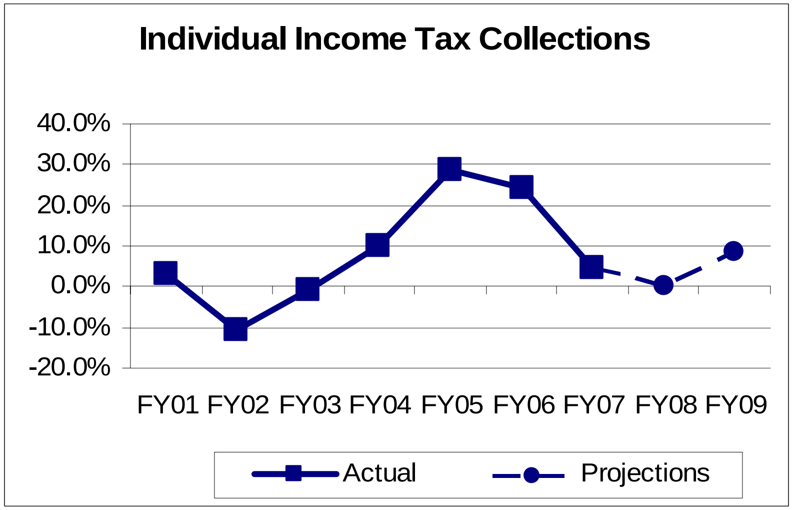
Individual Income Tax Collections: Over the last five years, Arizona individual income tax collections have displayed strong growth, fueled by solid wage and salary expansion and increases in capital gains and sole proprietor activity. In FY 2005, Individual Income Tax Collections grew 28.9% while personal income grew by 9.8%. Historically Arizona capital gains collections have been bolstered by strong equity markets and strong real estate markets. Continued strength from the equity market (stocks and bonds) component is expected to be offset by declining contributions from residential investor (non-owner-occupied) driven real estate. The resulting slower collections will be followed by a return to a rate that matches growth in the general economy. Withholding collections have continued to display modest growth – at about the overall pace of the economy. Slower overall collections in FY 2007 and FY 2008 reflect sequential 5% income tax rate reductions.

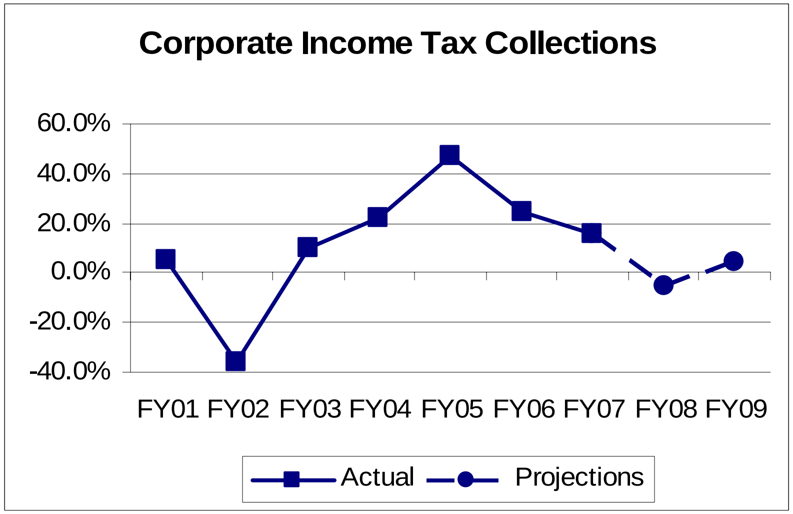
Corporate Profits: The underlying health of the Corporate sector in Arizona and growth in the profitability of companies with a strong presence in the State will likely continue to outstrip average profitability nationally. Corporate income tax collections growth will be modest as recent statutory changes (Corporate consolidation and Sales factor formulas) work through the system.

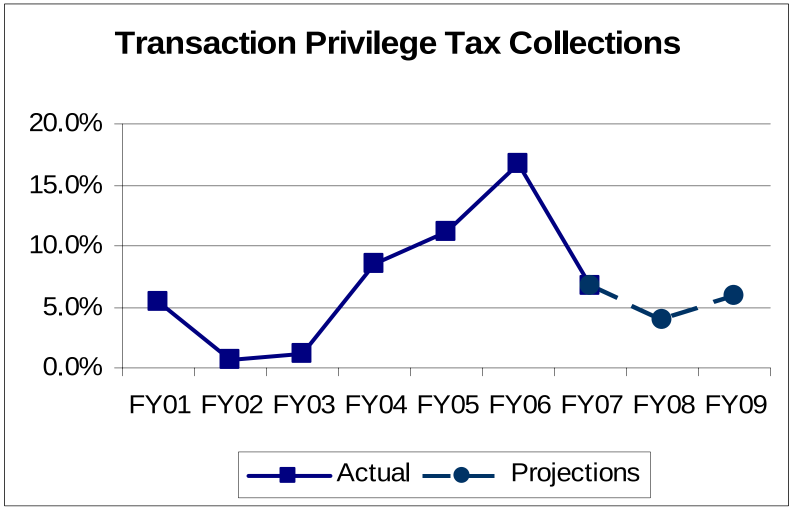
SECTION I – THE ECONOMY AND REVENUE

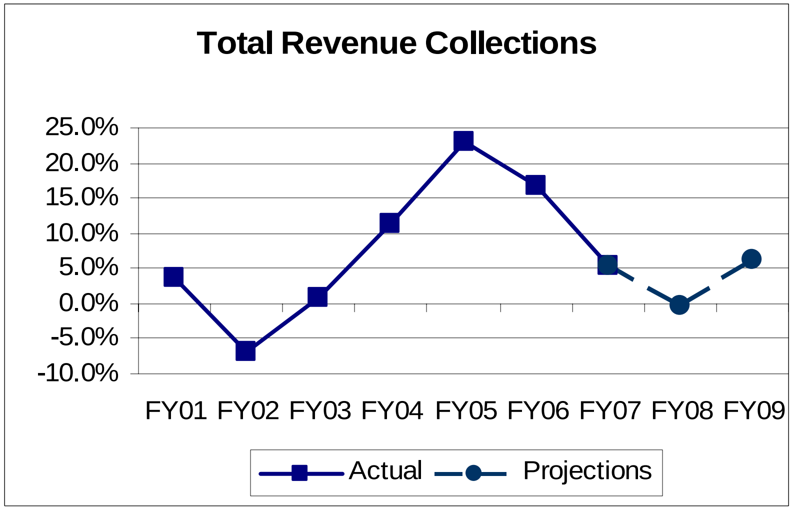
FY 2009
Revenue Forecast
General Fund
(in Millions)

	2008 Enacted Budget			Current 2008 Forecast		FY 2009 Forecast		
	1	2	3	4	5	6	7	8
	Actual FY 2007	Enacted Budget FY 2008	% change from (1) Actual FY 2007	Current Estimate FY 2008	% change from (1) Actual FY 2007	Current Estimate FY 2009	% change from (1) Actual FY 2007	% change from (4) Current Est FY 2008
Individual Income Tax	$3,735.7	$3,972.0	6.3%	$3,746.1	0.3%	$4,071.2	9.0%	8.7%
Corporate Income Tax	$986.2	$995.4	0.9%	$935.5	-5.1%	$974.7	-1.2%	4.2%
Transaction Privilege & Use Tax	$4,457.5	$4,899.9	9.9%	$4,633.2	3.9%	$4,905.1	10.0%	5.9%
Other Taxes	$492.7	$460.6	-6.5%	$507.3	3.0%	$534.0	8.4%	5.3%
Total Taxes	$9,672.1	$10,327.9	6.8%	$9,822.1	1.6%	$10,485.0	8.4%	6.7%
Non-Tax Revenues	$436.9	$387.7	-11.3%	$386.1	-11.6%	$357.6	-18.1%	-7.4%
Urban Revenue Sharing	($551.2)	($684.5)	24.2%	($684.5)	24.2%	($727.7)	32.0%	6.3%
TOTAL ALL REVENUES	**$9,557.7**	**$10,031.0**	**5.0%**	**$9,523.6**	**-0.4%**	**$10,114.9**	**5.8%**	**6.2%**


Individual Income Tax Collections
40.0%
30.0%
20.0%
10.0%
0.0%
-10.0%
-20.0%
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09
Actual
Projections


Corporate Income Tax Collections
60.0%
40.0%
20.0%
0.0%
-20.0%
-40.0%
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09
Actual
Projections


Transaction Privilege Tax Collections
20.0%
15.0%
10.0%
5.0%
0.0%
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09
Actual
Projections


Total Revenue Collections
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09
Actual
Projections

FY 2009
SOURCES AND USES
Description of Shortfall
($000)

	1 FY 2007 Actuals	2 FY 2008 Enacted Budget	3 FY 2008 Estimate Before Budget Management Plan	4 FY 2009 Estimated Before Executive Recommendation
SOURCES OF FUNDS				
Balance Forward	1,046,460.1	529,029.6	377,947.0	10,000.0
Adjustment to Balance Forward	(23,555.0)	0.0	0.0	0.0
Base Revenues	10,108,900.7	10,715,570.9	10,208,103.3	10,842,600.1
Urban Revenue Sharing	(551,230.7)	(684,538.9)	(684,538.9)	(717,127.6)
Urban Revenue Sharing FY03 and FY04 Repayment	0.0	0.0	0.0	(10,549.8)
Adjusted Base Revenues	9,557,670.1	10,031,032.0	9,523,564.4	10,114,922.7
SFB Building Renewal Transfer 1/	60,080.5	0.0	0.0	0.0
Ladewig Refunds	(80,735.9)	0.0	0.0	0.0
Unclaimed Property	0.0	45,000.0	45,000.0	0.0
Excess Balance Transfer from BSF	18,576.0	0.0	0.0	0.0
TOTAL SOURCES OF FUNDS	10,578,495.8	10,605,061.6	9,946,511.5	10,124,922.7
Operating Budgets	9,761,497.7	10,643,946.4	10,643,946.4	11,421,959.9
Reserve for Budget Supplemental Requirements	0.0	0.0	120,714.6	0.0
Payback K-12 Rollover 2/	191,000.0	0.0	0.0	0.0
Transfer to Rainy Day Fund (Budget Stabilization)	9,808.6	0.0	0.0	0.0
Nursing Pay Adjustments				1,000.0
Total Operating Budgets	9,962,306.3	10,643,946.4	10,764,661.0	11,422,959.9
Building Renewal and Capital Outlay	80,354.2	19,934.5	19,934.5	17,200.0
Highway Construction	245,000.0	0.0	0.0	0.0
Administrative Adjustments 3/	75,105.5	65,163.0	97,700.0	45,211.6
Revertments 4/	(162,217.2)	(125,283.1)	(75,352.6)	(79,960.7)
Reserve for Ending Balance	0.0	0.0	10,000.0	
USES OF FUNDS	10,200,548.8	10,603,760.8	10,816,942.9	11,405,410.7
ENDING BALANCE	377,947.0	1,300.8	(870,431.4)	(1,280,488.0)
TOTAL USES OF FUNDS	10,578,495.8	10,605,061.6	9,946,511.5	10,124,922.7

1/ In FY 2006, Laws 2005 Chapter 287 Section 9 required the transfer of $60 million from the Building Renewal Fund to the General Fund. This transfer was not implemented until FY 2007.

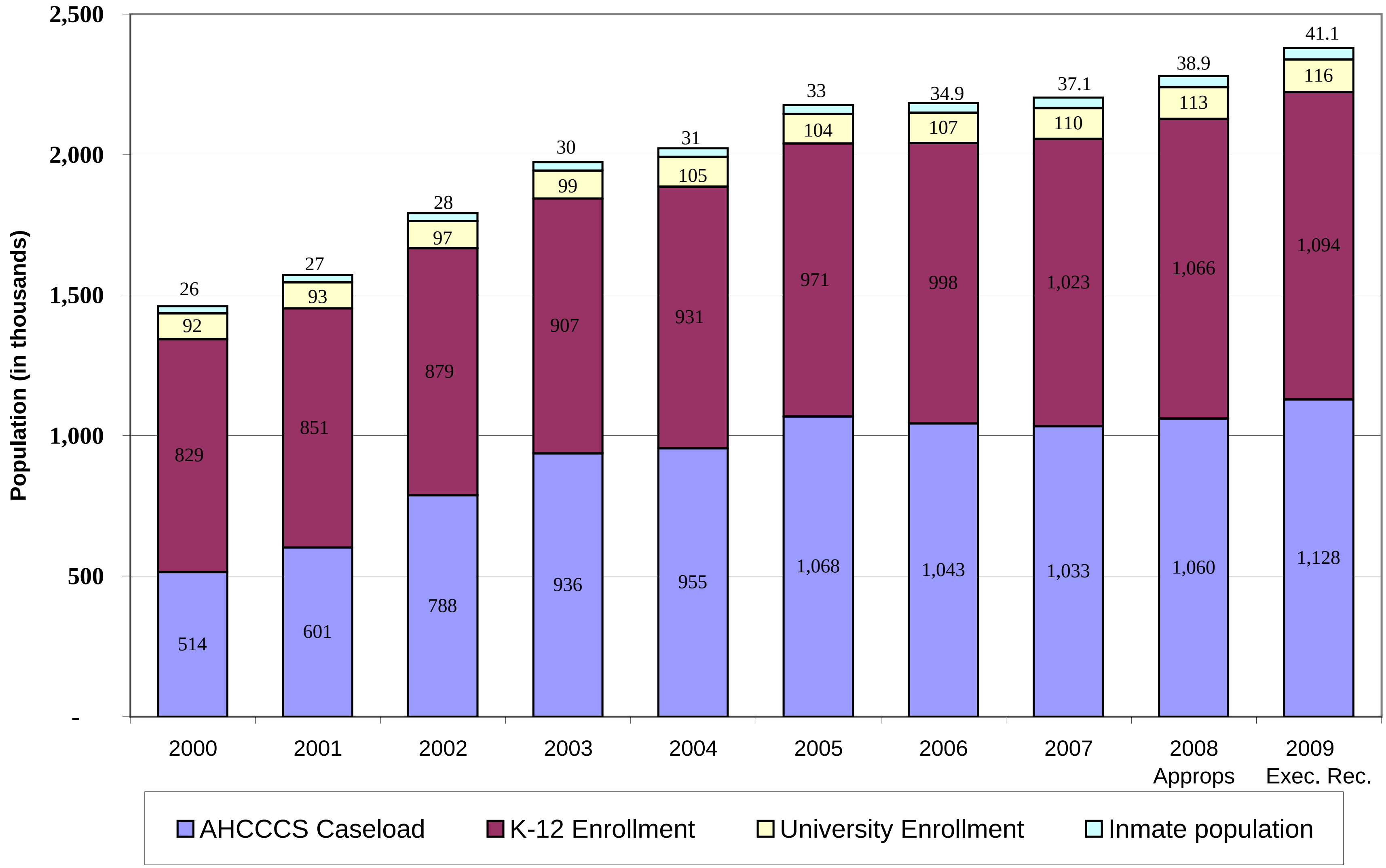
2/ $191M K-12 Rollover was recorded as a FY06 appropriation, but did not occur in FY06 as intended by the legislation since the effective date of the appropriation was beyond the end of FY06. Therefore this amount is shown in FY07.

3/ Administrative Adjustments reflect payments which occur after the fiscal year ends for goods and services purchased during the fiscal year. Typically these are the result of invoicing delays or the timing of payment processing. Because the accounting books have been closed for the fiscal year, the expenditures are counted in the subsequent year.

4/ Revertments reflect remaining unexpended agency appropriations at the end of the fiscal year. This is commonly the result of unrealized caseload or formula funding growth, vacancy savings, operating efficiency initiatives or other savings resulting from normal operations management. These are not the result of directed budget reductions which typically include decreased appropriations.

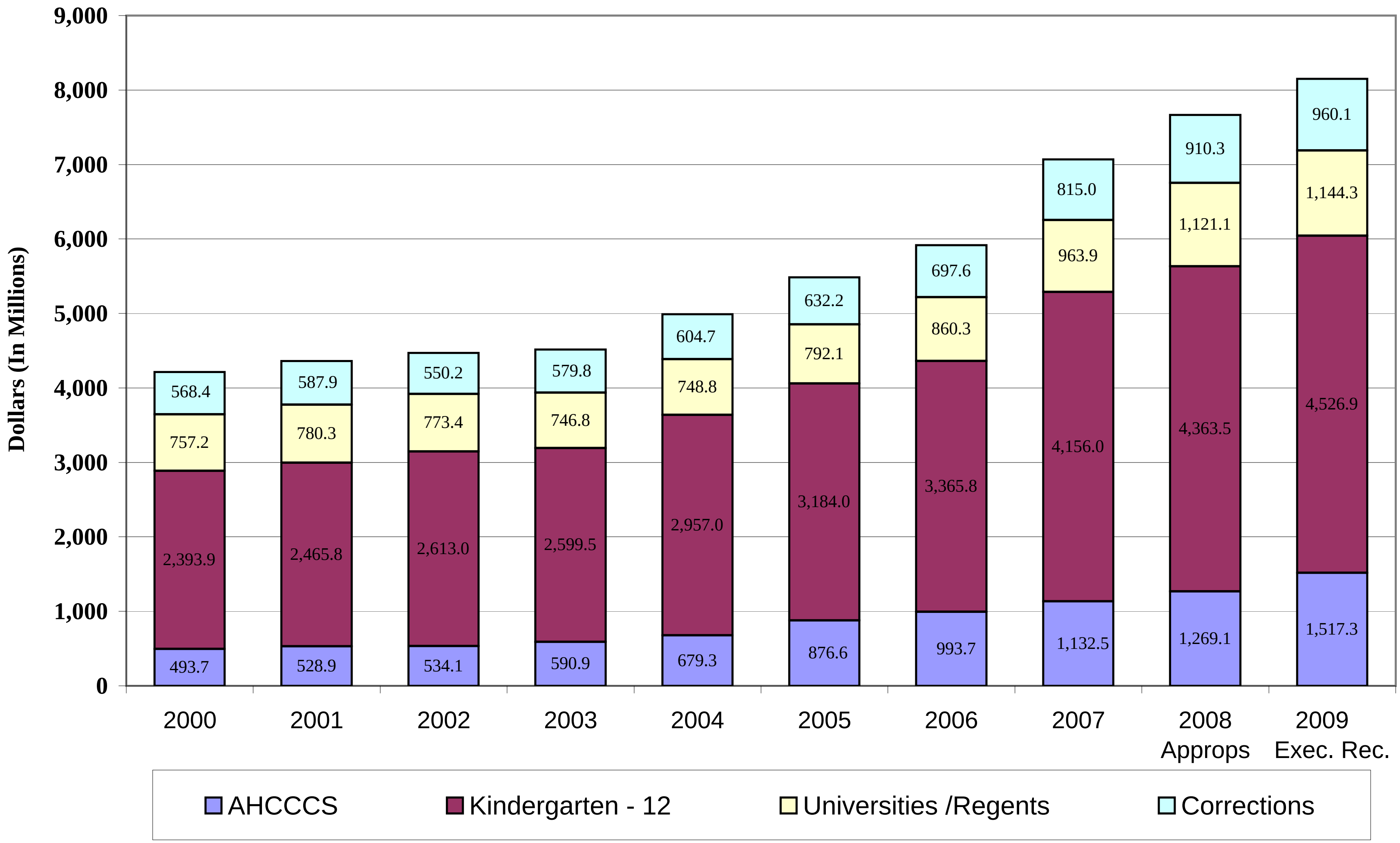
Caseload & Enrollment Populations

In FY 2009, caseload and enrollment for AHCCCS, K-12, Universities and Corrections are expected to grow by 100 thousand from FY 2008.



Funding Requirements for Caseload & Enrollment

This bar graph provides information on caseload, enrollment and inflation growth for AHCCCS, K-12, Universities, and Corrections, which amounts to $485 million. The total caseload, enrollment and inflation growth for all Executive agencies, including Department of Economic Securities, School Facilities Board, and Department of Health Services, amounts to $669 million.



GUIDING PRINCIPLES FOR THE FY 2009 BUDGET

- Maintain our commitment to efficiency and excellence and ensure that the integral functions of State government must not be compromised.
- Construct a fiscally prudent, balanced budget that does not raise taxes and maximizes the efficient use of the State's resources.
- Recommend spending reductions on an agency-by-agency and program-by-program basis, not across the board.
- Most importantly, protect Arizona's children and vulnerable populations by balancing the budget without cutting services to education, children or vulnerable populations.
- Reinforce our commitment to education, strengthening families, economic development, preservation of natural resources, and securing our borders.
- Invoke prudent fiscal measures that are necessary given the extraordinary circumstances we face.

FY 2009
OVERVIEW OF EXECUTIVE RECOMMENDATION
ADDRESSING THE SHORTFALL

The Executive Recommendation for addressing the shortfall consists of several primary components. First, is a **State agency budget savings strategy** which will reduce State general fund expenditures by $139.6 million in FY 2009. Second, we will initiate a **revenue generation** program which is expected to bring in $186 million. Third, a **K-12 Rollover,** delaying two week's worth of payments to July 2009 would reduce expenditures by $297 million. Fourth, it is once again time to tap the **State savings account** by utilizing $196.6 million of the nearly $700 million[1] in the Rainy Day Fund (BSF) as a short-term fiscal bridge. Finally, the use of **capital financing** in place of paying cash for school construction allows for lease purchase of $471.3 million of elementary and secondary school facilities during FY 2009. Additional detail regarding each of the components of the Recommendation is provided in the following pages. The following summarizes the key components of the Recommendation (in thousands):

Total Sources of Funds[2]	$10,124,922.7
Total Uses of Funds	($11,405,410.7)
FY 2009 Shortfall	**($1,280,488.0)**
Executive Recommendation Components	
1. State Agency Budget Savings	$139,580
2. Non Tax Increase Revenue Generation	$186,000
3. K-12 Rollover (two weeks)	$297,000
4. Rainy Day Fund ($225m remaining)	$196,558
5. K-12 Capital Financing	$471,350
Total Executive Recommendation	**$1,290,488**
Ending Balance	$**10,000**

[1] The cash balance of the Rainy Day Fund as of November 2007 was in excess of $685 million and will continue to add several million dollars each month through the end of the fiscal year. The Governor's FY 2008 Budget Management Plan recommends utilizing $263 million of this amount. After the transfers for both years, $225 million would remain in the fund.

[2] Includes a $10 million carry forward from FY 2008 after implementation of the Governor's FY 2008 Budget Management Plan.

EXECUTIVE RECOMMENDATION FOR ADDRESSING THE FY 2009 SHORTFALL

1. STATE AGENCY BUDGET SAVINGS
In thousands

Jail Incarceration	($60,814)	
Agency budget savings	($25,766)	
State Highway Fund	($53,000)	
Total Budget Savings		($139,580)

Jail Incarceration To ease the growth of the inmate population in Arizona prisons, low level, nonviolent types of offenders would serve their sentence in jails rather than being transferred to the more expensive prison system.

Agency Budget Savings Maintain numerous on-going agency savings as originally proposed for FY08.

State Highway Fund Shift funding for DPS highway patrol from the general fund to the state's portion[1] of the State Highway Fund.

2. NON TAX INCREASE REVENUE GENERATION
In thousands

Highway Photo Radar	$90,000	
TPT Estimated Payment Threshold	$55,000	
DOR Auditor/Collectors	$31,000	
Lottery	$10,000	
Total Revenue Generation		$186,000

Highway Photo Radar Enhance photo radar enforcement on the State's highways and dedicate the resulting revenue to DPS operations.

TPT Estimated Payment Reduce the TPT Estimated payment threshold to $100,000[2].

DOR Auditor/Collectors Enable the Department of Revenue to initiate seven measures intended to improve compliance and increase revenues[3].

Lottery Lift the advertising cap[4] on lottery games.

[1] This fund shift would not adversely impact the momentum on the highway construction program, nor would it have any direct financial impact on local government entities in terms of allocations made to them from the Highway User Revenue Fund.
[2] The estimated payment is in addition to the regular June TPT payment. Taxpayers pay only the remaining portion of their liability in July.
[3] Measures include standard revenue generation, collections delinquency, automation of bank matching/levy process, outsource collections inventory, increase the statute of limitations, increase criminal investigations, and increase license fees.
[4] Current law sets a cap of $11 million for advertising of lottery games.

EXECUTIVE RECOMMENDATION FOR ADDRESSING THE FY 2009 SHORTFALL

3. K-12 ROLLOVER - $297 million

The delay in the payment of the final month(s) apportionment (June 15th) of basic state aid and additional state aid to school districts from one fiscal year to the next fiscal year is commonly referred to as the "K-12 Rollover." The delay in the payment of state aid moves payment from the budget of one fiscal year to the budget of the next fiscal year. For FY09 the recommendation is to rollover two-week, or $297 million into FY 2010.

The first instance of the "K-12 rollover" occurred in 1988 as a means to balance the FY 1988 budget. In the several years following, the legislature increased the rollover to include increasing portions of the May 15th payment beginning in FY 1990 through FY 1993. A two week rollover was continued for FY 1994 and FY 1995 until Laws 1994, 8th Special Session, Chapter 3 established a trigger appropriation for repayment to fully pay the rollover. Any excess FY 1994 above $107,200,000 was appropriated to eliminate the rollover and any excess FY 1995 revenues above $4,237,100,000 were appropriated. The FY 1994 surplus was $229,204,400 and eliminated the rollover without further appropriation in FY 1995.

The rollover was next utilized in the FY 2003 budget. Laws 2002, 2nd Regular Session, Chapter 330 deferred $191,000,000 of basic state aid and additional state aid from June 15, 2003 to July 1, 2003 (thereby moving the aid obligation from the FY 2003 budget to FY 2004 budget.) In addition, $293,800 was appropriated in FY 2004 to offset interest costs incurred by school districts for "floating" the State for two weeks. The interest costs were calculated by JLBC using a 4% interest rate assumption. Laws 2006, Chapter 353 included $191,000,000 to repay the rollover in FY 2007.

4. RAINY DAY FUND TRANSFER - $196.6 million (BUDGET STABILIZATION FUND)

The Budget Stabilization Fund (BSF) for Arizona was enacted in 1990 (A.R.S. § 35-144). The BSF is designed to set revenue aside during times of above-trend economic growth and to utilize this revenue during times of below-trend growth. It is, in essence, the state's savings account. In prior years, the BSF has been tapped for uses not originally intended by the statute. For example, funds from the BSF were used to pay for the Arizona State Hospital in Fiscal Years 2000-2003 and in Fiscal years 2001-2007 BSF funds were transferred for payments on the Alternative Fuels Tax Credit. The use of the BSF in the Governor's Budget Management Plan is exactly consistent with the intended use of the fund.

The current cash balance in the BSF is in excess of $685 million[1]. The Governor's Budget Management Plan for FY 2008 would use $263 million of this amount. The Governor's proposal for FY 2009 is to transfer $196.6 million to the General Fund to help balance the budget, utilizing the BSF for its intended purpose. This leaves $225 million plus any unrealized investment gains in the BSF.

[1] Through November 2007.

EXECUTIVE RECOMMENDATION FOR ADDRESSING THE FY 2009 SHORTFALL

5. K-12 CAPITAL FINANCE – $471 million

The School Facilities Board allocates funds to school districts for construction of new schools and maintenance of existing schools. Of the nearly $639 million in the FY 2009 Executive Recommendation for the School Facilities Board, the general fund component of $167.5 million covers the agency's operating budget, existing debt service costs, and the cost of building renewal projects. The remaining $471 million is to cover new construction, including adequate funding for full day kindergarten and school safety and these components would be financed.

Financing New Schools – Improving the K-12 Capital System

The State of Arizona expects to spend $471 million on new school construction in FY 2009. When the Arizona economy is growing in an up cycle, it has been customary in those years to pay cash for new schools from the general fund. However, with lower than expected revenues and higher than expected new school construction costs, the State must look to other means to provide for K-12 capital needs. The Governor has proposed financing the cost of building new schools. There are several reasons why financing new school costs are the right step for Arizona.

1. In almost every state, state and local governments use long-term financing for new schools.

2. Long-term financing is used by families, businesses, and local governments to acquire long-term capital assets.

3. The state uses capital financing for the construction of government buildings, universities and for roads.

4. Future Arizonans will benefit from schools built today for the next 50 years so it is fair for future Arizona beneficiaries share in the cost of building and financing their schools.

5. Current financing market conditions are favorable. Long-term financing would likely cost the state an interest charge below 5 percent.

6. The new school construction program needs to be expanded to accommodate full-day kindergarten. Financing provides the ability to complete this expansion today.

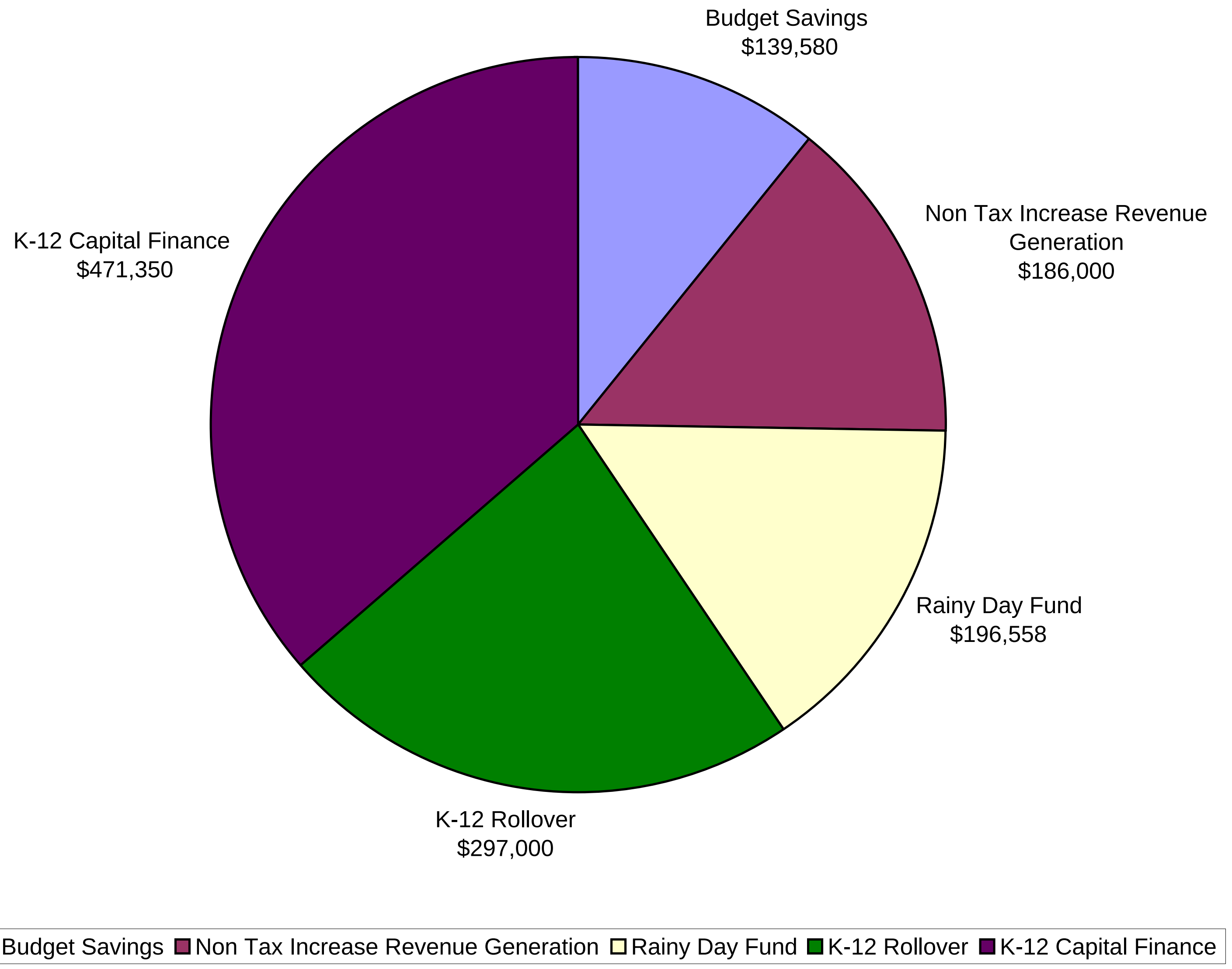
7. Financing new schools creates opportunities to implement 21st century improvements in school infrastructure including improvements in energy, safety, and technology.

8. Financing in FY 2009 will free $471 million in General Fund dollars for other priorities.

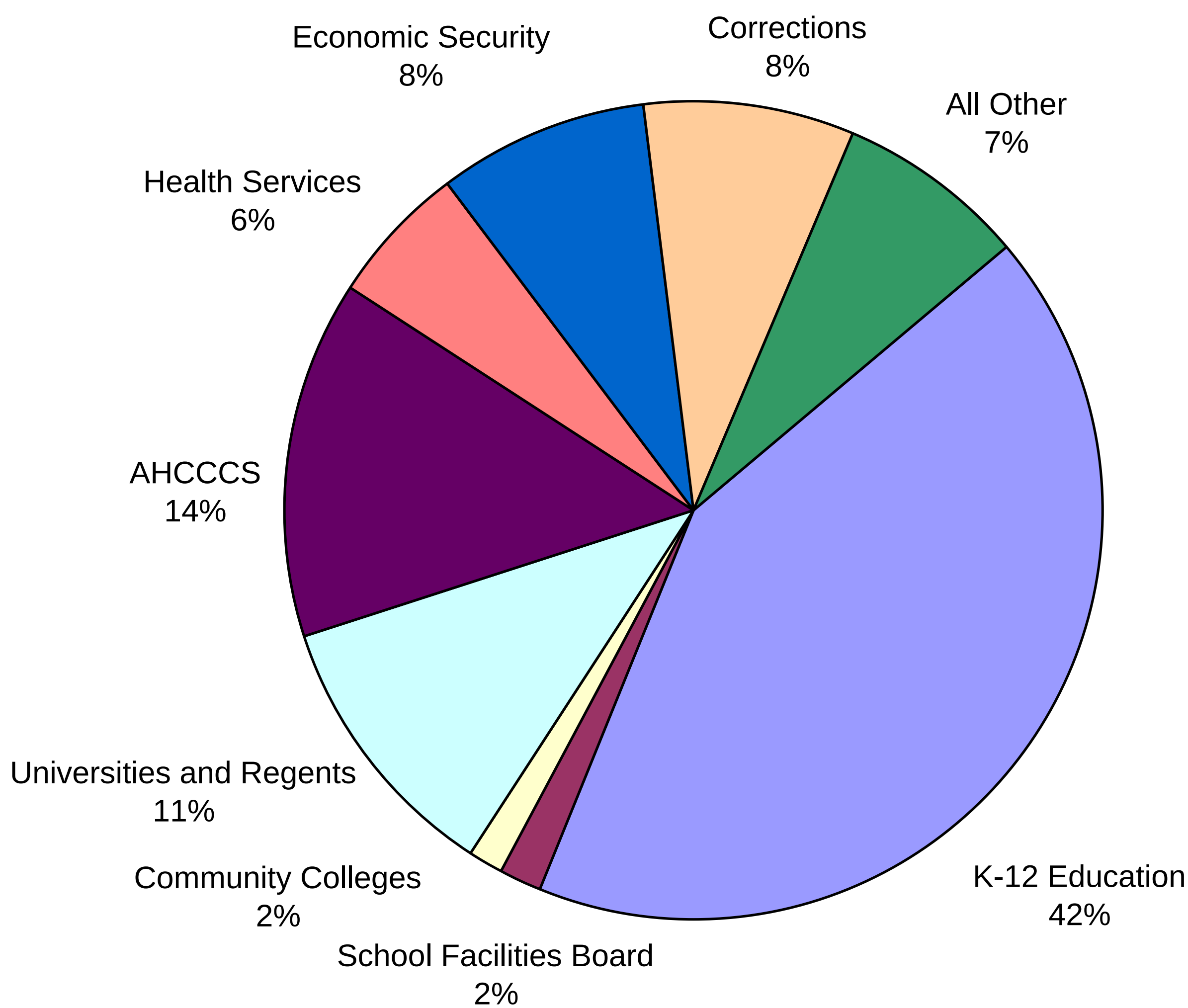
9. Over the next five years, long-term financing would reduce the General Fund cost of new school construction by $2.2 billion allowing the State to invest in other critical areas such as, healthcare, K-12 education, universities and public safety.

10. New schools are capital assets with a use period exceeding 50 years. Roads, as a comparison, only have a 30 to 40 year expected life.

FY 2009 EXECUTIVE RECOMMENDATION FOR ADDRESSING THE SHORTFALL (000s)



FY 2009 General Fund Executive Budget Recommendation



K-12 Education	$4,526,855.9
School Facilities Board	167,496.3
Community Colleges	172,911.6
Universities and Regents	1,144,318.7
AHCCCS	1,517,326.1
Health Services	614,258.4
Economic Security	878,711.8
Corrections	898,663.7
All Other	801,487.4
Total	**10,722,029.9**

FY 2009 General Fund Executive Recommendation: Expenditure Growth Breakdown

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Agency	*FY 2008 Appropriations*	*Caseload Requirements and Inflation Growth*	*Statutory, Federal and Court Mandates*	*Extension of Existing Programs*	*Technical and Other Adjustments*	*Executive New Initiatives*	*FY 2009 Executive Recommendation*
Administration	33,312	-	-	-	(5,907)	-	27,405
AHCCCS	1,269,136	250,924	-	9,274	(13,724)	1,717	1,517,326
Community Colleges	167,745	6,167	-	-	(1,000)	-	172,912
Corrections	910,277	45,724	-	-	3,476	(60,814)	898,664
Economic Security	794,336	52,143	3,500	10,124	18,609	-	878,712
K-12 Education	4,363,465	166,501	-	-	(3,110)	-	4,526,856
Health Services	583,432	35,278	-	1,240	(5,691)	-	614,258
Juvenile Corrections	81,450	-	-	-	(1,500)	-	79,950
Public Safety	177,708	-	120	-	(142,596)	-	35,231
School Facilities Board	532,695	90,000	-	-	(466,549)	11,350	167,496
Universities	1,121,095	20,723	-	4,500	(10,500)	8,500	1,144,319
All Other Agencies	609,294	2,176	-	3,658	32,582	11,190	658,901
Total Agency Operating Budget	10,643,946	669,636	3,620	28,796	(595,911)	(28,057)	10,722,030
Percent of growth over FY 2008 Appropriations		6.3%	0.03%	0.3%	-5.6%	-0.3%	0.7%

net = -5.6%

CATEGORIES FOR BUDGET DEPICTION

1. Caseload and Inflation

Caseload changes are due to an increasing or decreasing number of customers and assume no FY 2009 changes to the FY 2008 level of service for customers and enrollees.

Inflation refers to changes in unit cost for an expenditure item in FY 2009 compared to FY 2008. Inflationary increases can include things like the annual price adjustments in the contracts for independent service providers, the cost of utilities, and the price of food.

2. Statutory, Federal and Court Mandates

Statutory Mandates are permanent changes to Arizona Revised Statutes or temporary session laws that may be accompanied by funding. If the funding was not provided or is insufficient, a budget recommendation could follow.

Federal and Court Mandates include mandates from any court and from changes to Federal law or requirements imposed by Federal agencies.

3. Extension of Existing Program

This includes changes related to increasing the type of customers that participate in an activity or the type of services provided to customers, or expanding the scope or range of an existing program or activity.

4. New Initiatives

New Initiatives include new services or activities not related to the expansion of existing programs.

5. Technical and Other Adjustments

These include rent, insurance premiums, changes to existing employee-benefit costs, and backing out one-time costs (for such things as equipment).

General Fund Agency Operating Budget Summary ($ in thousands)

	FY 2009 Executive Recommendation
Annual Budget Agencies	
Arizona Department of Administration	27,405.3
Arizona Health Care Cost Containment System	1,517,326.1
Arizona Community Colleges	172,911.6
Department of Corrections	898,663.7
Department of Economic Security	878,711.8
Department of Education	4,526,855.9
Department of Health Services	614,258.4
Judiciary	128,221.5
Department of Juvenile Corrections	79,949.8
Department of Public Safety	35,231.1
School Facilities Board	167,496.3
Department of Transportation	84.6
Universities	
Arizona Board of Regents	20,598.0
ASU - Tempe	420,221.0
ASU - Polytechnic	32,066.2
ASU - West	56,820.8
Northern Arizona University	169,522.8
University of Arizona - Main Campus	362,782.0
University of Arizona - Health Sciences Center	82,307.9
Subtotal - Universities	1,144,318.7
Biennial Budget Agencies	
Office of Administrative Hearings	1,209.4
Arizona Department of Agriculture	12,444.4
Arizona Commission on the Arts	2,078.1
Attorney General - Department of Law	21,527.3
Arizona Biomedical Research Commission	1,000.0
State Capital Post-Conviction Public Defender Office	1,979.2
State Board for Charter Schools	1,051.0
Department of Commerce	16,901.4
Corporation Commission	5,366.8
Arizona Criminal Justice Commission	4,002.0
Arizona State Schools for the Deaf and the Blind	20,747.2
Department of Emergency and Military Affairs	14,696.8
Department of Environmental Quality	31,561.3
Governor's Office for Equal Opportunity	245.2
State Board of Equalization	639.5
Board of Executive Clemency	1,027.4
State Department of Financial Institutions	4,030.8
Department of Fire, Building and Life Safety	3,564.5
Arizona Geological Survey	1,013.9

	FY 2009 Executive Recommendation
Government Information Technology Agency	9,394.8
Office of the Governor	6,909.8
Governor's Office of Strategic Planning and Budgeting	2,204.9
Arizona Historical Society	4,383.8
Prescott Historical Society of Arizona	732.0
Arizona Commission of Indian Affairs	220.9
Department of Insurance	7,005.2
State Land Department	25,167.8
Law Enforcement Merit System Council	72.2
Legislature	
Auditor General	17,626.9
House of Representatives	13,854.8
Joint Legislative Budget Committee	2,948.6
Legislative Council	5,576.1
Arizona State Library, Archives & Public Records	7,536.3
Senate	9,193.0
Subtotal - Legislature	56,735.7
Department of Liquor Licenses and Control	3,397.1
Board of Medical Student Loans	1,500.0
State Mine Inspector	1,769.8
Department of Mines and Mineral Resources	829.9
Arizona Navigable Stream Adjudication Commission	0.0
State Board of Nursing	166.0
OSHA Review Board	0.0
State Parks Board	28,305.0
Personnel Board	357.9
Arizona Pioneers' Home	1,236.0
Commission for Postsecondary Education	7,420.8
Arizona Department of Racing	2,682.4
Radiation Regulatory Agency	2,220.7
Arizona Rangers' Pension	13.7
Department of Real Estate	4,221.0
Department of Revenue	78,478.6
Department of State - Secretary of State	6,975.0
Statewide Adjustments	78,078.5
State Board of Tax Appeals	304.2
Arizona Office of Tourism	16,322.2
State Treasurer	5,384.5
Commission on Uniform State Laws	0.0
Department of Veterans' Services	8,220.6
Department of Water Resources	23,167.7
Department of Weights and Measures	1,630.2
General Fund Operating Total	**10,722,029.9**

A SIX-YEAR SUMMARY OF EFFICIENCY REVIEW INITIATIVES

In Thousands of Dollars

Statewide Initiatives	*2004 Actual*	*2005 Actual*	*2006 Actual*	*2007 Actual*	*2008 OSPB Est.*	*2009 OSPB Est.*	*Six-Year Total*
Employee Benefits	0.0	0.0	25,000.0	48,000.0	59,000.0	59,000.0	191,000.0
Energy Conservation	0.0	442.8	205.0	205.0	367.4	382.4	1,602.6
Leasing/Space Utilization	0.0	1,543.0	1,200.0	0.0	400.0	400.0	3,543.0
Fleet Consolidation	0.0	922.0	1,074.9	922.0	929.9	929.9	4,778.7
Statewide E-Procurement	0.0	15,700.0	22,295.0	45,000.0	37,712.0	24,717.0	145,424.0
Total: Statewide Initiatives	**0.0**	**18,607.8**	**49,774.9**	**94,127.0**	**98,409.3**	**85,429.3**	**346,348.3**
Total: Agency Initiatives	**30,041.2**	**87,304.4**	**166,296.4**	**88,507.1**	**158,494.7**	**333,283.8**	**863,927.6**
TOTAL: ALL INITIATIVES	**30,041.2**	**105,912.2**	**216,071.3**	**182,634.1**	**256,904.0**	**418,713.1**	**1,210,275.9**

FINANCIAL SUCCESS

According to data compiled by the Governor’s Office of Strategic Planning and Budgeting (OSPB), by the end of FY 2009 the agency-specific and statewide projects developed through ER will have saved the taxpayers an estimated $1.2 billion since its inception in 2003.

AGENCY-SPECIFIC SAVINGS

Agencies are continually challenged to create new ideas for efficiency savings. Agency-specific efficiency savings achieved in FY 2007 from fully and partially implemented projects totaled approximately $88.5 million.

If an initiative is a “cost avoidance” – i.e., a permanent or long-term savings – it is accounted for in each year of the five-year plans in which the avoidance applies. If an initiative is a cost savings – i.e., a temporary or short-term savings – it is accounted for in the year(s) it applies. By the end of the current fiscal year, cumulative project savings since FY 2004 are expected to total almost $791.6 million.

Technology. Agencies have utilized technology to convert paper processes to forms of electronic communication. Several agencies are now completing license renewals on-line, and many are converting mailings for items such as reports, newsletters and various other documents to Internet formats for public viewing.

Hiring Gateway, the new paperless recruiting and hiring system implemented for all agencies, was able to achieve savings of close to $2.1 million in FY 2007 and is estimated to save the State approximately $2.3 million more by the end of FY 2008. In addition, the Department of Revenue has been successful in encouraging tax payers to file their tax returns on line through the recently developed E-File web-based application.

Human Resources. Several agencies have increased the number of volunteers and volunteer hours to alleviate some of the pressures caused by a lack of funding for additional staff. One agency has implemented a Virtual Office initiative (initially discussed above in “The Future of ER”) that, by allowing employees to work from their homes, reduces costs associated with leased office space and employee turnover.

Reduction of Red Tape. Process streamlining has also achieved savings. While some agencies have consolidated the number of required forms by reducing duplicative questions, others have also been conducting process reviews and eliminating unnecessary steps.

Consolidation of Boards and Commissions. The Governor has made it a priority to streamline government. At the Governor’s request, the Efficiency Review Team identified over 50 boards, councils, commissions and agencies that are being consolidated or eliminated. This will result in a smarter, leaner state government. This initiative will consolidate similar functions and will shrink administrative costs while improving public services. Any cost savings are likely to be realized in FY 2010.

K-12, UNIVERSITIES, BUILDING RENEWAL AND NEW CONSTRUCTION
FY 2009

K-12 The Executive recommends a five-year commitment to financing new school construction to provide that steady foundation upon which Arizona's children can learn and build better lives and better communities.

The School Facilities Board (SFB) funds the construction of approximately 34 schools per year. Since 1999, paying for school construction has been accomplished in any one year utilizing either cash (i.e., General Fund appropriations) or lease-to-own financing. For FY 2009, the Executive Recommendation includes financing $471 million. By financing the estimated $2.6 billion in school construction needed through 2013, the cost to the general fund for debt service during the five year period is expected to be approximately $341 million. This is a financially sound strategy, particularly during lean economic times.

UNIVERSITIES In order to effectively compete in today's global economy, Arizona requires a highly educated and skilled workforce. Our State universities play a critical role in meeting this need and although the State and our universities have made significant investments in new capital facilities designed to address this growth and to expand their research capabilities, critical needs still must be addressed.

University Capital Acceleration Program. The State cannot continue to defer the capital needs of its universities. Arizona's growing population and the critical need to invest in the State's capital assets to stay current and competitive in the field of higher education requires that it do more. The Executive recommends establishing a Capital Acceleration Program (CAPs) to create a pool of funds that the universities can leverage to meet these immediate needs.

Phase I. This phase requires legislation authorizing financing of the $470 million to complete the Arizona Biomedical Campus. The research and education buildings are a joint venture of the three universities, which will share the facility. Financial authorization will be structured to provide that initial payments on the bonds will be made in FY 2010.

Phase II. Address remaining capital needs *(see table below)* on each university campus, including building renewal, major renovations, and years of deferred maintenance. Additionally, the universities need additional classroom space and infrastructure to accommodate enrollment growth. By maintaining existing buildings at their fullest capacity, major expenditures in building replacement will be avoided. The first debt service payment for the $966 million in capital needs will be in FY 2011.

	Project	**Cost** (Millions)
UA	Deferred Maintenance and Building Renewal	$130.7
UA	Environment & Natural Resources Building	70.0
UA	Social & Behavioral Sciences Building	44.0
UA	Engineering Research Building	70.0
UA	Centennial Hall Renovation	12.0
NAU	Deferred Maintenance and Building Renewal	169.0
NAU	Health Professions Facility Expansion	100.0
NAU	Undergraduate Classroom Building	41.0
ASU	Deferred Maintenance and Building Renewal	226.0
ASU	Enrollment Growth Infrastructure	80.0
ASU	School of Construction	23.8
	TOTAL	$966.5

Meeting the universities' capital needs will require significant funding, which in turn will require utilizing multiple sources of revenue to establish or seed the CAPs program. Potential funding sources include:

- The State's General Fund
- University tuition and registration fees
- Indirect cost recovery monies generated from university research grant
- Student housing revenues
- Other user-related fees
- Sales of university assets
- Additional revenue generators
- Other auxiliary enterprise funds
- University interest earnings

By creating the funding mechanism under the CAPs program, the State will establish a long-term funding solution to meet the deferred maintenance and capital requirements of Arizona's university system and to continue laying the groundwork for the state's future.

BUILDING RENEWAL AND CAPITAL OUTLAY

The Executive recommends $17.2 million from the General Fund in FY 2009 for building renewal and capital outlay.

ADOA Building System - CAPITAL IMPROVEMENTS

The Executive recommends $9 million from the General Fund in FY 2009 for capital improvements and major maintenance projects. The recommendation includes:

- $3.2 million for Phase III to secure and replace non-working prison cell doors and locks throughout the Corrections system;

- $5.8 million to repair and replace building systems, including fire, emergency, air ventilation and electrical systems at buildings used by the:
  - Department of Juvenile Corrections
  - Department of Administration
  - Department of Economic Security
  - Department of Revenue

During prior Legislative sessions, the Legislature approved General Fund expenditures of

- $1.5 million for DPS communications systems (Laws 2006, Chapter 345), and

- $4.7 million for capital projects (Laws 2007, Chapter 257).

ADOA Building System - BUILDING RENEWAL

The Executive Recommendation provides $11.6 million for Building Renewal, including $2 million from the General Fund.

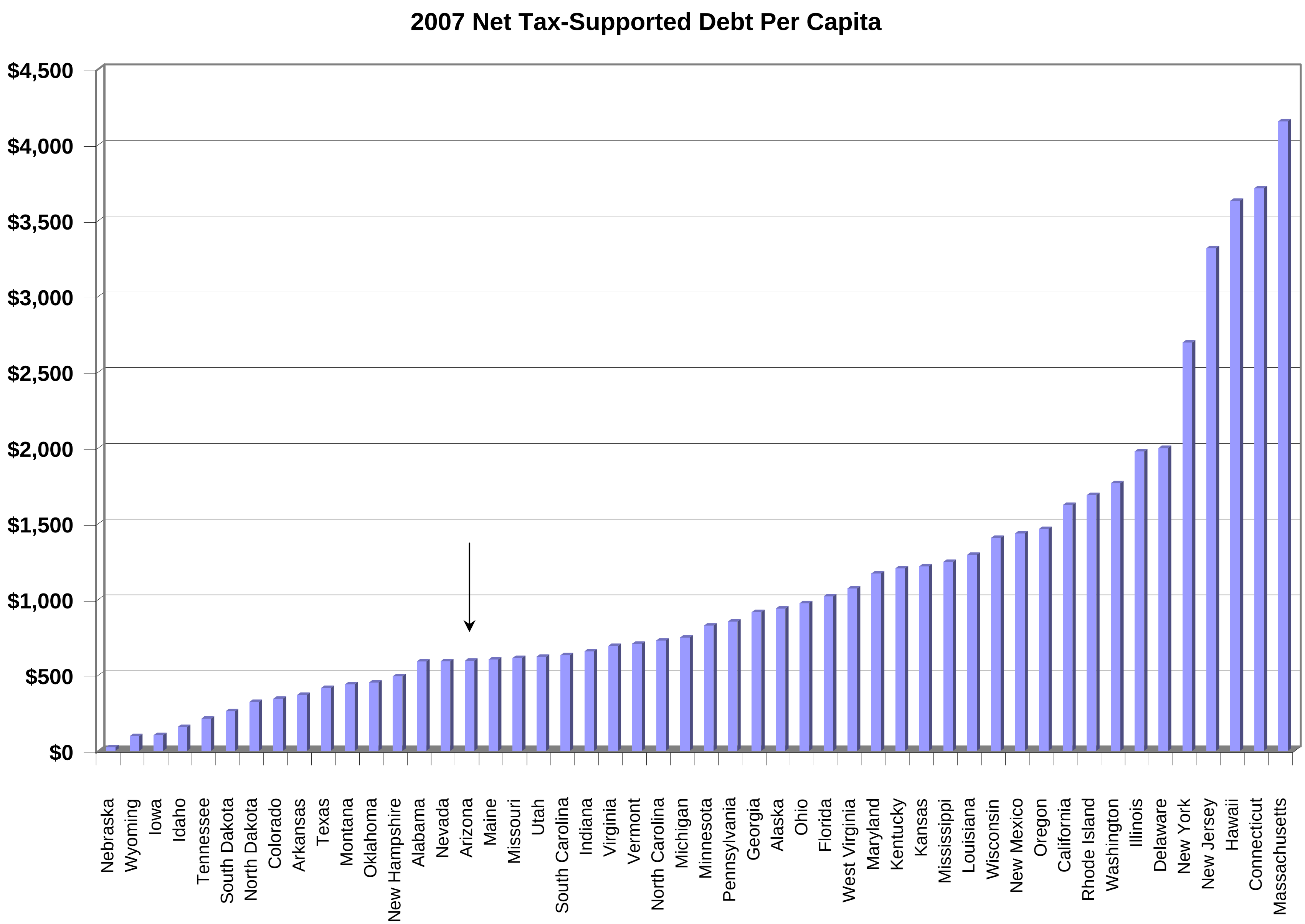
APPENDIX A – ARIZONA'S BOND RATINGS

Governor Napolitano's fiscal policies and prudent debt management have resulted in increased and stable credit rating for Arizona. The rating agencies' independent assessments speak well of the State's fiscal stewardship and the improved credit ratings since 2004 have resulted in significant interest savings on State borrowed funds.

State of Arizona's Bond Ratings

Rating Service/ Debt Type	2003	2004	2005	2006	2007
Moody's Investors Service					
General State Credit	No Rating	Aa3 Stable Outlook	Aa3 Stable Outlook	Aa3 Stable Outlook	Aa3 Stable Outlook
Certificates of Participation	A1 Negative Outlook	A1 Stable Outlook	A1 Stable Outlook	A1 Stable Outlook	A1 Stable Outlook
Standard & Poor's					
General State Credit	No Rating	AA Stable Outlook	AA Stable Outlook	AA Stable Outlook	AA Stable Outlook
Certificates of Participation	AA- Negative Outlook	AA- Stable Outlook	AA- Stable Outlook	AA- Stable Outlook	AA- Stable Outlook

- Arizona's "AA" level general credit ratings reflect a very strong profile.
- Arizona is judged by Moody's to be of high credit quality and subject to very low credit risk.
- Moody's April 2007 publication ranked Arizona:
  - 35th in nation in net-tax-supported debt per capita (down from 32nd in 2006)
  - The mean per capita debt of the 50 states was $1,101 compared to Arizona's $594
  - 33rd in the nation in debt as a percentage of 2005 personal income
  - The mean debt as a percentage of personal income of the 50 states was 3.2% compared to Arizona's 2.0%



Graphical representation was produced from information from Moody's Investors Service of Net Tax-Supported Debt

STATE DEBT RANKINGS

2007 Net Tax-Supported Debt Per Capita		
1	Massachusetts	$4,153
2	Connecticut	$3,713
3	Hawaii	$3,630
4	New Jersey	$3,317
5	New York	$2,694
6	Delaware	$1,998
7	Illinois	$1,976
8	Washington	$1,765
9	Rhode Island	$1,687
10	California	$1,623
11	Oregon	$1,464
12	New Mexico	$1,435
13	Wisconsin	$1,405
14	Louisiana	$1,294
15	Mississippi	$1,247
16	Kansas	$1,218
17	Kentucky	$1,204
18	Maryland	$1,171
19	West Virginia	$1,071
20	Florida	$1,020
21	Ohio	$974
22	Alaska	$939
23	Georgia	$916
24	Pennsylvania	$852
25	Minnesota	$827
26	Michigan	$747
27	North Carolina	$728
28	Vermont	$706
29	Virginia	$692
30	Indiana	$657
31	South Carolina	$630
32	Utah	$621
33	Missouri	$613
34	Maine	$603
35	**Arizona**	**$594**
36	Nevada	$591
37	Alabama	$590
38	New Hampshire	$492
39	Oklahoma	$450
40	Montana	$439
41	Texas	$415
42	Arkansas	$370
43	Colorado	$343
44	North Dakota	$322
45	South Dakota	$261
46	Tennessee	$213
47	Idaho	$157
48	Iowa	$104
49	Wyoming	$97
50	Nebraska	$24
	MEAN:	$1,060
	MEDIAN:	$754
	Puerto Rico	$7,312

** This figure is not included in any totals, averages, or median calculations but is provided for comparison purposes only.*

2007 Net Tax-Supported Debt as a % of 2005 Personal Income		
1	Hawaii	10.6%
2	Massachusetts	9.4%
3	Connecticut	7.8%
4	New Jersey	7.6%
5	New York	6.7%
6	Illinois	5.5%
7	Delaware	5.5%
8	New Mexico	5.3%
9	Washington	5.1%
10	Louisiana	4.9%
11	Mississippi	4.9%
12	Oregon	4.6%
13	Rhode Island	4.6%
14	California	4.4%
15	Kentucky	4.3%
16	Wisconsin	4.2%
17	West Virginia	3.9%
18	Kansas	3.7%
19	Florida	3.1%
20	Georgia	3.0%
21	Ohio	3.0%
22	Maryland	2.8%
23	Alaska	2.7%
24	Pennsylvania	2.4%
25	North Carolina	2.4%
26	Utah	2.3%
27	South Carolina	2.3%
28	Michigan	2.2%
29	Minnesota	2.2%
30	Vermont	2.1%
31	Indiana	2.1%
32	Alabama	2.0%
33	**Arizona**	**2.0%**
34	Missouri	1.9%
35	Maine	1.9%
36	Virginia	1.8%
37	Nevada	1.7%
38	Oklahoma	1.5%
39	Montana	1.5%
40	Arkansas	1.4%
41	Texas	1.3%
42	New Hampshire	1.3%
43	North Dakota	1.0%
44	Colorado	0.9%
45	South Dakota	0.8%
46	Tennessee	0.7%
47	Idaho	0.6%
48	Iowa	0.3%
49	Wyoming	0.3%
50	Nebraska	0.1%
	MEAN:	3.2%
	MEDIAN:	2.4%
	Puerto Rico	66.3%

** This figure is based on 2005 Personal Income. It is not included in any totals, averages, or median calculations but is provided for comparison purposes only.*

Source: Moody's Special Comment April 2007 Edition

K-12 CAPITAL FINANCING

Arizona continues to experience the second highest rate of population growth in the country. Due to this growth, Arizona school districts require the construction of over 30 new schools ranging from elementary to high schools during this fiscal year. As part of our ongoing commitment to quality education while balancing the State's fiscal needs, the plan utilizes lease-to-own financing[1] for new school construction, returning cash to the General Fund without cutting back on school construction or lowering facility standards. Financing through a lease-to-own system ensures the State retains the resources to continue providing superior facilities to Arizona's expanding communities during a time of unprecedented growth.

Comparison of cost of Lease-to-Own vs. Cash for construction to fund new schools

There has been on going debate whether the annual cost of Lease-to-Own will exceed the annual cash cost and at what point in the future this will occur. To address this issue, the following charts have been prepared and it should be noted that the answer to that question depends on your assumptions about the future of Arizona. The three key variables in this analysis are population growth, inflation, and cost of financing.

Population Growth While everyone agrees that Arizona will continue to grow, there is much dispute over how fast and for how long. For this analysis, three growth scenarios are shown. Chart 1 assumes a constant rate of growth of 2.87 percent. This rate is based on work done at the University of Arizona. Chart 2 is based on the Department of Economic Security (DES) published projections. DES assumes that the rate of growth will decline over time. They reflect this by reducing growth rates from 2.86 percent in 2009 to 1.07 percent in 2040. Chart 3 assumes a flat rate of 2 percent growth to provide a comparison point between the DES and U of A models.

Inflation Rate Projecting inflation over the next thirty-years is more difficult that population projections. Since July of 2000, the JLBC has adopted an official rate of inflation for Arizona school construction. These adoptions reflect inflation from July 1, 1999 to July 1, 2006. During this period, Arizona has experienced both a recession and an economic boom. Therefore, the average of these adopted rates should be a good reflection of inflation going forward. The average rate is 4.92 percent.

Cost of Financing The average rate for thirty-year financing for the last 10 years is 5.37 percent. Current rates are under 5 percent. While no one can project where rates will be over the next 30 years, in order to present a relatively conservative analysis a 5.5 percent rate, slightly higher than the 10-year average is used below.

As shown in the attached charts it is clear that paying cash for construction over the next 30 years will place a greater burden on the State General Fund. During Arizona's growth period, financing schools will free billions of dollars in State General Fund monies that can be used for other expanding needs in education, public safety, health care and corrections.

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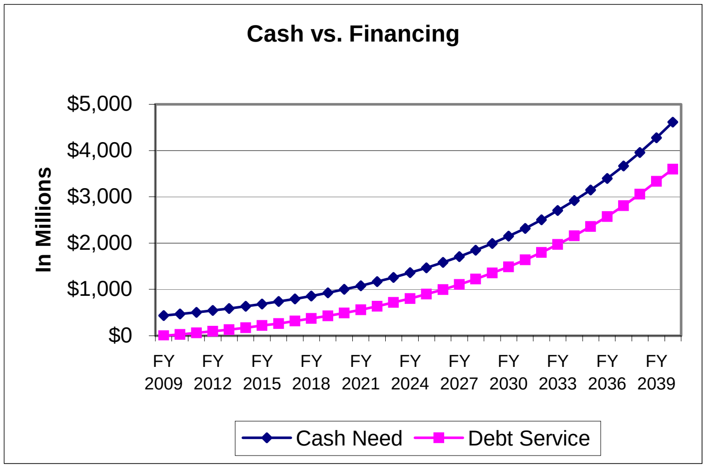
[1] **Difference between Lease-to-Own and Revenue Bonding**

Revenue Bonding Revenue Bonding is a form of debt financing where an issuer borrows money from an investor or group of investors and agrees to pay a fixed principal sum on a specified date at a specified rate of interest. The issuer pledges as security for the bonds a specified revenue stream (property taxes, sales taxes or system revenues such as highway fund revenues, for example) that will be used to make the required debt payments. Repayment of the bonds is not subject to an annual appropriation and no property is pledged as collateral due to the pledge of the revenue stream. The credit rating on the bonds and subsequently the interest rate at which the funds can be borrowed is dependent upon the strength and credit quality of the pledged revenue stream.

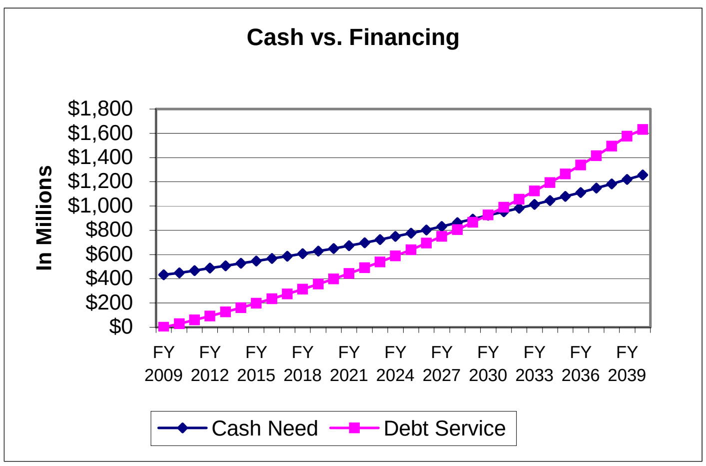
Lease-to-Own Lease-to-Own is a form of lease purchase financing. The financing is generally provided by the issuance of certificates of participation through a banker or other entity and lease payments made by the borrower as the lessee match the debt service payments due on the certificates. The lease payments made are subject to annual appropriation and the property being financed serves as collateral securing the financing similar to a mortgage. Given their security structure, lease to own financings may only be used in situations with good collateral value and where the project is deemed essential to the governmental entity with no appropriation risk. Lease-to-Own financings are not viewed legally as "debt" because payment is tied to an annual appropriation by the governing body. As no revenue stream is pledged, certificates of participation are seen by rating agencies and investors as a weaker credit structure than revenue bonds and the interest rates paid by the lessee on the certificates are marginally (10 to 15 basis points) less favorable than for comparable Revenue Bonds.

Chart I
Growth Rate – University of Arizona's Estimate: 2.87%, Inflation Rate: 4.92%, Cost of Financing: 5.5%



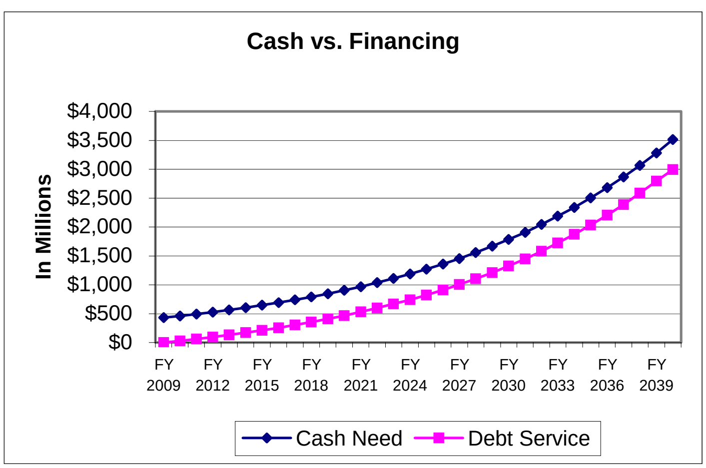
The result of the assumptions for Chart I is that the cost of financing will not cross the cost of the program within the next 30 years. **Over this period, using financing will save the State $19.6 billion**.

Chart II
Growth Rate – DES Estimate: 2.86% to 1.07%, Inflation Rate: 4.92%, Cost of Financing: 5.5%



The result of the assumptions in Chart II is that the cost of financing will exceed the cost of the program in 2030 or 21 years from next fiscal year. Over that 21 year period, the cost of financing will be $5.4 billion less than that the cost of the cash program. **Over the entire period shown, the cost of financing will be $3.3 billion less than the cost of the cash program**.

Chart III
Growth Rate: 2%, Inflation Rate: 4.92%, Cost of Financing: 5.5%



Again under these assumptions, the cost of the financing will not exceed the cost of the program within the next 30 years. **Over this period, the cost of financing will be $14.4 billion less than the cost of the cash program.**